

# Different at the Core

**A** bond fund that doesn't particularly emphasize yield may surprise you, but this approach fits well into the philosophy of the Oppenheimer Core Bond Fund. High yields are associated with high risk, and that is something the Fund's managers try to avoid. Different from its peers, the fund focuses on what investors expect from a core bond allocation – consistent, competitive risk-adjusted returns.

**Q:** What is the philosophy of your fund and how it differs from your peers?

**A:** We see three major differentiators in the way we manage the Fund. We don't believe in forecasting interest rates; we have a team approach to managing the portfolio; and we view research and technology as a critical component of our competitive edge, not just as a back-office function.

Our philosophy is grounded in the belief that return is a function of risk. Therefore, we identify major security and portfolio risks and hedge against unintended exposures on a daily basis. We also don't look at the portfolio by security type only. Instead we slice and dice the pieces of risks within each security and aggregate them by risk type. Our approach requires a significant amount of research and technology and we use quantitative models that enable us to look at statistical relationships and correlations between different market sectors.

Another differentiator is that we believe it is better for investors to have a team of experts that specialize in different areas of the markets instead of one manager. Our team, which has been in place at OppenheimerFunds since April 2002,

consists of five investment experts. In addition to these five, we have another eight analysts and traders working on the fund. We have found that our "swat-team" approach eliminates bias as traditional managers (what I like to call the "Jack-of-All-Trades Manager") tend to rely on their strong subjects and overlook the others with which they are not as familiar.

The biggest differentiator is that our decisions are not based on interest rate forecasts. Traditionally, fixed income managers are expected to know where interest rates are headed at all times and to construct their portfolios accordingly. Forecasting with consistent accuracy is nearly impossible and we think it is a loser's game.

Although we don't forecast interest rates, we do position our portfolio to benefit from their direction through the use of quantitative tools we have built that help us understand what the implicit market's rate forecast is over longer horizons.

**Q:** How do you translate this philosophy into an investment strategy?

**A:** Our neutral point is the index—we don't spend much time thinking about our absolute return, but always think rel-

## Fund Facts

Symbol	OPIGX
Website	<a href="http://www.oppenheimerfunds.com">www.oppenheimerfunds.com</a>
Address	OppenheimerFunds, Inc. Two World Financial Center 225 Liberty St., 11th Floor New York, New York, 10281
Tel. No.	1.888.470.0862
Inception	4/15/88

## Portfolio

Total Net Assets *	\$ 835.9
Turnover Ratio	67.0

## Investment Information

Min Initial Investment	\$ 1,000.00
Min Subsequent Investment	\$ 50.00
Min Initial IRA Investment	\$ 500.00

## Risk (Against LB Aggregate Bond Index - 3 Years)

Alpha	1.09
Beta	0.93
R-Squared	93.57
Ann Std Deviation (5 years)	4.09
Sharpe Ratio	1.01

## Returns vs. Lipper Interm Inv-Grade Debt Funds

	OPIGX	Index
1 Year (Cum.)	4.30 %	4.38 %
3 Year (Ann.)	18.43 %	16.75 %
5 Year (Ann.)	36.68 %	38.75 %

## Returns vs. LB Aggregate Bond Index

	OPIGX	Index
1 Year (Cum.)	4.30 %	4.15 %
3 Year (Ann.)	18.43 %	15.35 %
5 Year (Ann.)	36.68 %	40.11 %

## Fees and Expenses

Max Sales Charge - Front	4.75 %
Max Sales Charge - Deferred	0.00 %
Total Expense Ratio	0.90 %

## Portfolio Manager

Angelo Manioudakis and High Grade Bond Team  
(Charles Moon, Ben Gord, Geoff Caan,  
Antulio Bomfim)

\* millions

Data through: 08/31/05

Source: Company Documents; Lipper



**TICKER'S Choice**

ative to the Lehman Aggregate Bond Index or the Citigroup "BIG" Index. When advisers invest with us, we assume they want allocation to the U.S. Bond market, and our goal is to outperform the index in this area.

Starting with the benchmark, there are three major ways to add value - sector selection, security selection, and active management of duration. We first review the different sectors to determine whether to over- or under-weight them. Then we focus on security selection and decide on, for example, buying the cheapest mortgage or avoiding a potentially risky corporate. Also, we often raise or lower duration relative to the benchmark to take an active view on interest rates.

Another important point to make is that we do not pursue yield as an objective. We are a total return fund, meaning that we look for the best return possible through any combination of yield and price appreciation. Yield is closely associated with risk and if you are always optimizing to the highest yield, you are, on average, creating a high risk portfolio.

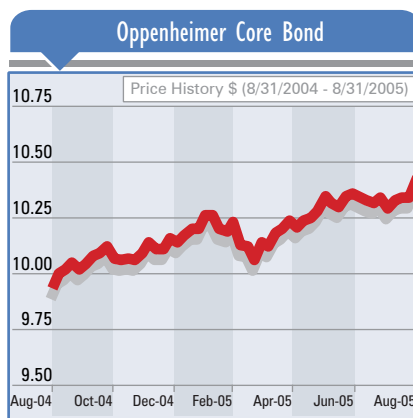
When considering the right amount of risk to take, we think in terms of tracking error versus the benchmark. If we can outperform our index by about 100 - 150 basis points a year, that translates into consistently good competitive rankings relative to our peer group. We are not aiming for a top ranking over the short term because that usually requires too much risk. But we seek to achieve above-average rankings consistently over a long period of time. Above-average rankings over a sustained period eventually drives the fund to the first quartile over long periods.

**Q:** *From a longer-term perspective, what is the strategy leading to out-performance on a continuous basis?*

**A:** A cornerstone of our portfolio is the mortgage sector. We run a relatively high percentage of mortgages - 35% to 60% depending on the environment - because there is structural alpha in the mortgage market. For example, homeowners in this country have the expectation that they have the right to prepay their mortgages. Because there are so

many homeowners demanding that right, they have to pay us an extra premium each year for that option. That always gives mortgages extra yield compared to Treasuries. Historically, mortgages have outperformed Treasuries consistently. During the past 21 years, mortgages underperformed Treasuries with the same duration in only 2 years. In addition, with mortgages you don't have to worry about credit risk. They are AAA rated and are as liquid as Treasuries.

The key, however, in our mortgage strategy is getting duration right. Mortgage duration is very volatile as interest rates move because of the prepayment risk. We have built a propriety model that allows us to monitor this prepayment risk, hedge it out, and remove it as unintended.



**Q:** *Could you explain your research process in terms of the buy and sell discipline?*

**A:** One important part of the research process is in the corporate area. Investment grade bonds, which typically represent 25% to 30% of the portfolio, require a lot of research on individual names, similar to the process of equity portfolio managers. Our analysts go through the companies' balance sheets and income statements and talk to rating agencies and company management.

Typically, investors are not worried about investment grade companies defaulting and therefore the effort to research them may seem useless. While it is true that there aren't many defaults in the investment-grade world, our research focuses on the changes in the credit qual-

ity of companies, which is a much more important determination of value for normal environments.

An example of this would be with Chesapeake Energy, a company that was rated investment grade when we owned it. Our research at that time suggested that the company's credit quality was deteriorating, so we decided to sell the bonds. The bond didn't look like it would default, but the deterioration in credit quality caused the bonds to drop by about 5 points. This price volatility is a good example of why our research is so important.

Another key aspect of our research process relates to managing duration. We know that the market's forecast, based on what's "priced-in" to the yield curve, is not a good predictor of rates. We are therefore especially interested in situations when the market is making an obviously extreme forecast. Because we know that the probability is high that this extreme forecast will not be accurate, we often lean against such extremes. We do this by shortening or lengthening the portfolio's duration.

Please note, these trades do not happen frequently, maybe only a few times a year. The portfolio is neutral in duration, relative to our benchmark, until an opportunity presents itself. Then we position the duration accordingly and after it is over, we go back to neutral.

**Q:** *Do you invest in the high-yield sector?*

**A:** We have limited and tactical exposure to securities below investment grade, usually in the range of 0% to 5%. We invest primarily in "cross-over" names, or bonds that may be rated investment grade by one agency and just below investment grade by another. The high-yield market tends to shun these securities because they are not "yieldy" enough, while investment grade buyers cannot always purchase these securities, due to investment constraints. As a result, they are often neglected and we see this as a great opportunity. They have quasi investment-grade characteristics, but are cheaper than they should be.

**Q:** *What is the risk control aspect of the fund management discipline?*

**A:** Even though we do our homework, it isn't reasonable to assume that we'll avoid every single problem, so we manage risk at multiple levels.

At the security level, we keep small position sizes. For corporate bonds, they decline in size with credit quality. Our average exposure to a company is about 0.4% of the portfolio and that's less than half the exposure of a typical bond fund. If there is a blow-up, we make sure that we can weather it. Core bond funds are meant to be a safety net for investors who also have equities and alternative investments. They are not meant to express bets on companies like the equity side of a portfolio.

At the duration level, we actively manage duration versus the benchmark, setting a risk tolerance of plus or minus three quarters of a year. These constraints are important because shifting your duration to be longer or shorter than your benchmark can add a tremendous amount of volatility to performance.

One reason we have been very consistent in our peer rankings because our interest rate risk is narrower.

**Q:** *When deciding your exposure on the corporate side, do you take into consideration merger situations?*

**A:** On the equity side, a fair amount of money can be made on mergers, but on the fixed income side, a fair amount of money can be lost from M&A activity. The trend in credit quality of corporate America has been down for 30 years as corporations become more savvy about optimizing their capital structures. In the current stage of the business cycle, with low yields and a well-performing stock market, management teams, and especially buy-out funds, have extra cash and feel they have to do something with the cash for their shareholders, so they are starting to make deals. When they want to make deals, it often involves more leverage, which means more pressure on credit quality, ratings, and spreads.

We are cautious now because M&A risk is high and has the potential to hurt the corporate bond market.

**"Core bond funds are meant to be a safety net for investors to buffer the volatility that may exist in their more aggressive investments. They are not meant to pursue aggressive bets as that is the purpose of for the equity side of an investor's portfolio."**



about **Angelo G. Manioudakis**

**Angelo Manioudakis** is a Senior Vice President and Portfolio Manager who leads the Oppenheimer High Grade Investment Team. Along with his portfolio team, he manages Oppenheimer Limited Term Government Fund, Oppenheimer U.S. Government Trust, Oppenheimer Core Bond Fund, the fixed-income portion of Oppenheimer Real Asset Fund, and those Oppenheimer variable account funds, which have similar investment policies. In addition to those duties, the team also contributes to the selection of the domestic investment grade bonds included in the portfolios of several other Oppenheimer fixed income funds and balanced funds.

Mr. Manioudakis joined Oppenheimer Funds after eight years at Morgan Stanley Dean Witter, where most recently he served as an Executive Director and Portfolio Manager in the Miller, Anderson, Sherrerd (MAS) division of Morgan Stanley Investment Management.

**Q:** *How many securities do you hold in your portfolio?*

**A:** As previously stated, we have a very diverse portfolio, with on average 200 to 250 securities. But part of our large diversification is due to the different pools of mortgages. Sometimes different mortgages may have 20 to 50 little pools and that creates the illusion of more positions. We typically have about 80 to 100 corporate bonds.

**Q:** *Aren't there too few investment grade companies nowadays in the US?*

**A:** There are still about 1000 companies, but a lot of them are small companies that have issued just once and this tends to obscure the numbers. There are probably 250 big, household names such as GE or IBM who are regular active issuers on the market. That's the area where we do most of the mining for ideas because they are well-known names, trading every day, with ample liquidity.

**Q:** *Can you give us an example of the peculiarities of research on the corporate bond market? What is your advantage over your peers?*

**A:** One example is our strategy of focusing on short maturity corporates and overweighting them. There has always been a demand for long-maturity corporates from big insurance companies – some of the largest participants on the bond market – who tend to chronically overpay for longer-maturity corporates. Because there aren't many natural buyers for the shorter bonds, they are cheaper.

When you buy a short-maturity bond, the analysis is simplified. You need to figure out whether the bond will make it through maturity in a year, if the company has enough liquidity and cash. A 30-year bond is much more complex because it acts like an equity, and its performance is a lot more volatile. Owning short-maturity corporates simplifies analysis, gives us an edge on the market and limits the volatility in the portfolio. ■

**TICKER Staff**